

Differentiating Alternatives from Ambiguity

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Financial reporting needs clear, consistent, logically coherent, and unambiguous standards to support the creation of quality financial information in financial reports. This is contrast to financial reporting standards which might be vague, inconsistent, logically incoherent, and ambiguous.

Consistent and having allowed alternative and options are different situations which people commonly confuse.

In the financial reporting world we can live with clear, known alternatives or options. Professional accountants use their judgment to pick and choose amongst those known alternatives or options; applying what they consider the best alternative given all available alternatives or options. Exercising professional judgment is and should be part of financial reporting.

What financial reporting cannot live with are diverse interpretations which result in different results based on the exact same facts due to standard definitions and principles that are vague, inconsistent, logically incoherent, and ambiguous. A different understanding of the exact same facts is not judgement; it is lack of clarity, lack of consistency, lack of coherence, and ambiguity. You can have different interpretations of facts, that is judgment.

The vagueness, inconsistencies, logically incoherent, and ambiguities in the definitions and principles used in financial reporting standards are not alternatives or options; they are unintended errors in the standards.

Accounting professionals determine the difference between errors and differences in interpretation.

The FASB or IASB and others in the financial reporting supply chain aspire to create clear, consistent, logically coherent, and unambiguous definitions and principles which make up financial reporting standards. The definitions and principles are consciously, deliberately, methodically, and rigorously worked out specifications of the concepts and ideas which are used to express

information in financial reports which are then used within the financial reporting supply chain. Vagueness, inconsistencies, incoherence, and ambiguities are minimized.

When humans try and describe complicated things such as financial reporting standards in books it is easy to inadvertently make mistakes which contribute to vagueness, inconsistencies, incoherence, and ambiguities because the only way to check the meaning which is written is manually using humans.

However, when financial reporting standards are described using machine-readable formats¹ to express such information; then machines can be used to help humans check to make sure there is no vagueness, inconsistencies, logical incoherence, or ambiguities in the definitions and principles which make up the standards. Machines will never be able to check everything, but there are certain things they can do better than humans.

The financial accounting conceptual framework created by the FASB contributes to this clear, consistent, logically coherent, and unambiguous terminology and principles by providing a disciplined framework² which can be used to think about financial accounting. A discussion of the framework in a FASB special report states in part:

- Providing a set of common premises as a basis for discussion
- Provide precise terminology
- Helping to ask the right questions
- Limiting areas of judgment and discretion and excluding from consideration potential solutions that are in conflict with it
- Imposing intellectual discipline on what traditionally has been a subjective and ad hoc reasoning process

However, given the idiosyncratic tendencies of humans, interpretations which reflect the arbitrary peculiarities of individuals can sometimes slip in or mistakes can be made when expressing such terminology. Further, parts of our understanding of financial reporting can be incorrect and can evolve and improve and may even simply change over time.

¹ See the paper *An analysis of fundamental concepts in the conceptual framework using ontology technologies* which can be found here: <http://xbrl.squarespace.com/journal/2015/4/19/accountants-understand-utility-of-ontology-for-reducing-ambi.html>

² Per FASB Special Report, *The Framework of Financial Accounting Concepts and Standards* (1998)

If different groups of professional accountants use different terminology for the same concepts and ideas to express the exact same truths about financial reporting; those professional accountants should be able to inquire as to why these arbitrary terms are used, identify the specific reasoning for this, and specifically identify concepts and ideas which are the exact same as other concepts and ideas but use different terminology or labels to describe what is in fact exactly the same thing; and to also understand the subtleties and nuances of concepts and ideas which are truly different from other concepts and ideas.

If idiosyncrasies result only in different terms and labels which are used to express the exact same concepts and ideas, then mappings can be created to point out these different terms used to express the same concepts and ideas. Such mappings make dialogue more intelligible and could get groups to accept a single standardized term or set of terminology for the purpose of interacting with common repositories of information, such as XBRL-based financial filings of public companies.

If the difference in terminology and expression are rooted in true and real theoretical differences between professional accountants, and the different terms express and point out important subtleties and nuances between what seemed to be the same terms; then these differences can be made explicit and discussed, in a rigorous and deliberate fashion within the accounting profession once the differences are made explicit.

While accumulating and articulating this information in the form of books and other human readable resources adds to the discipline and rigor of clearly, logically, coherently, unambiguously defining concepts and ideas; articulating this information in machine-readable fashion takes the discipline and rigor to an entirely new level. Further, other new and interesting possibilities and flexibility are opened up because this information is expressed in machine-readable form.

And so while many professional accountants believe the purpose of the US GAAP XBRL Taxonomy is simply being something necessary for public companies to create and provide XBRL-based financial reports to the SEC; the reality is that it is much, much more than this.

The US GAAP XBRL Taxonomy is a communications tool which will improve the clarity, logical coherence, consistency, reduce ambiguity, and improve

overall quality of US GAAP based financial reporting for both public and private companies.

Below I provide three examples of vagueness, inconsistencies, logical incoherence, or ambiguousness observed in the financial reports of public companies which have been submitted to the SEC in digital form using the global standard XBRL. Because the financial reports are XBRL-based and therefore machine-readable 100% of the population of financial reports can be tested.

These three examples are intended to show the possibilities which are opened up because information is structured and therefore machine-readable.

Inconsistent financial position segmentation schemes

Wiley GAAP 2011 (page 46 to 48) points out inconsistencies in the financial position segmentation schemes used within the Accounting Standards Codification (ASC). Different schemes are required for various reporting purposes and depending upon specific circumstances. However, those different schemes use inconsistent and sometimes conflicting terminology. The *Wiley GAAP 2011* goes as far as providing a standard taxonomy which organizes and specifically describes these segmentations:

The Parent Holding Company <i>Owns subsidiaries, land and headquarters building that they all use</i>						
Subsidiary 1 <i>Division a Business i</i>	Subsidiary 2 <i>Business iv</i>	Subsidiary 3 <i>Business v 2 Product Lines</i>	Subsidiary 4 <i>2 Similar Businesses Business vi</i>	Subsidiary 5 <i>2 Similar Businesses Business viii</i>	Subsidiary 6 <i>Business ix</i>	Subsidiary 7 <i>2 Nonsimilar Businesses Business x</i>
Asset Group (a)	Asset Group (d) with Primary Asset	Asset Group (e) and Disposal Group (f)	Asset Group (g)	Asset Group (i)	Asset Group (j)	Asset Group (k) Reporting Unit (6)
Reporting Unit (1)	Reporting Unit (2)	Reporting Unit (3)	Reporting Unit (4)	Reporting Unit (5)		Business xi
<i>Division b</i>			Business vii			Asset Group (l) Reporting Unit (7)
Business ii	Business iii		Asset Group (h)			
Asset Group (b)	Asset Group (c)					
Operating Segment A		Operating Segment B	Operating Segment C	Operating Segment D		Operating Segment E
Reportable Segment I			Reportable Segment II	Reportable Segment III		Reportable Segment IV

When trying to decipher the segmentation of entities in XBRL-based public company financial filings to the SEC it should be possible to locate the root

economic entity³ and then navigate down the hierarchy of segments. I have no data on whether it is or is not possible or to what extent the hierarchy can be navigated; however, for a small minority of public companies it is not even possible to identify the root economic entity. Out of 6,751 entities analyzed⁴, the root economic entity could be found for 6,720 or 99.5% but not for 31 public companies or .5%. The fact that 99.5% of root economic entities can be found is evidence that some scheme for discovering the starting point of entity segmentation is very possible. No attempt was made to analyze the next layer of segmentation because there is so much inconsistency between public company XBRL-based financial reports.

It would be very hard to get the XBRL-based information consistent given the inconsistency in US GAAP.

Variability in reporting Income (loss) from Equity Method Investments

Per an analysis of 9,679⁵ public company XBRL-based financial filings to the SEC, 1,048 or about 11% of economic entities reported the line item *Income (loss) from equity method investments*. Of the 1,048 public companies which reported that line item; the following is a summary of where on the income statement the line item was reported:

- 624 entities (60%) reported the line item before tax directly as part of income (loss) from continuing operations before tax
- 128 entities (12%) reported the line item as part of nonoperating income (loss)
- 110 entities (10%) reported the line item after tax as part of special reporting items
- 20 entities (2%) reported the line item as part of revenues
- 22 entities (2%) reported the line item with income tax expense (benefit), between income (loss) from continuing operations before and after tax

³ The SEC refers to this as the entity of focus.

⁴ Understanding Public Company XBRL-based Financial Report Quality, see <http://xbrl.squarespace.com/journal/2015/4/7/understanding-public-company-xbrl-based-financial-report-gua.html>

⁵ This analysis was done on 2013 information and can be found here, <http://xbrl.squarespace.com/journal/2014/10/14/options-for-dealing-with-line-items-that-bounce-around-incom.html>

- 10 entities (less than 1%) reported the line item as part of costs and expenses
- 8 entities (less than 1%) reported the line item as part of operating expenses
- 126 entities (12%) reported this information in some other manner which was not specifically identified.

As a professional accountant, I did not even realize that this sort of variability was allowed. Intuitively, I was surprised and found it hard to believe that this amount of variability was useful. Other accountants I spoke with were likewise surprised that income (loss) from equity method investments could be reported in so many locations on the income statement. I am not saying that any of these reporting entities did anything wrong. I am simply making an observation. Financial analysts I spoke with said this idiosyncrasy was one of the top 10 things that needed to be changed about financial reporting. These observations raise the following questions in my mind.

- What is the purpose of this variability? Are there legitimate reasons why entities which use US GAAP have so much flexibility with this line item and not nearly the flexibility with other line items?
- Why exactly does this variability exist for this line item, but other line items do not have nearly so much variability? Are the accounting standards ambiguous? Was it a conscious choice to allow this level of variability, or was it caused by a sloppily written accounting standard?
- What would happen if someone like the SEC or FASB would say, "This line item always goes after tax with other special reporting items, similar to discontinued operations and extraordinary items." Could the FASB or SEC do this? Should the FASB or SEC do this? Would analysts be happy about this or would they not like this to be forced into one slot on the income statement?

I am not saying that I have appropriate answers to these questions. However, I do believe that these are reasonable questions.

Exchange gains (losses) in two locations in cash flow statement

An analysis of 6,751 entities showed that 2,169 or 32% reported the line item Exchange gains (losses) from foreign currency transactions on their

cash flow statement⁶. Of those 2,169 entities; there were two approaches to reporting that line item:

- 2,068 or 95%: Beginning balance in cash + Net changes in cash = Ending balance in cash (*i.e. exchange gains are included within net change in cash*)
- 101 or 5%: Beginning balance in cash + Net changes in cash + Exchange gains (losses) from cash transactions = Ending balance in cash (*i.e. exchange gains are included in the roll forward between beginning and ending cash, not within net changes in cash*)

Originally, the US GAAP XBRL Taxonomy provided for only the first alternative which was used by the majority of public companies. Eventually, the US GAAP XBRL Taxonomy was modified to include both alternatives.

When talking with a number of other professional accountants, one indicated that the second alternative was a reporting error and the alternative used by the 95% of public companies was the only allowed alternative. Another accountant stated that there was nothing that prohibited the lesser used alternative.

These questions come to my mind about this situation:

- Are there really two (or maybe even more) ways of computing the value of the line item net change in cash?
- If alternatives exist, what is the specific reason for the alternative? What is the specific benefit that this variability provides?
- Would there be benefit to only having one alternative in order to improve financial report comparability?

Again, to be clear I am not saying that I know the answer to these questions or that any public company is doing anything incorrectly; rather am only raising the questions based on this observation.

⁶ An earlier version of this analysis can be found here, <http://xbrl.squarespace.com/journal/2009/11/24/issue-relating-to-effect-of-exchange-rate-on-cash-and-cash-e.html>

Understanding Accounting Consistency and Comparability

The conceptual framework of the FASB uses the terms consistency and comparability in precise ways which may be different than how many people understand and define these terms.

Accounting *comparability* helps users of financial reports see similarities and differences between the reported transactions, events and circumstances when analysts try and compare information across entities. A part of accounting comparability is *consistency* of accounting practices across time periods which allows for the comparison across different periods for the same entity.

Entities must be consistent in applying their accounting policies to allow for comparability across time periods. For example, an entity cannot simply use the FIFO approach to valuing inventory in one period, change to LIFO in another period, and then back to FIFO. That is an inconsistent application of accounting policies.

While information across entities should be comparable that is not to mean that information is reported identically. For example, some entities report using a classified balance sheet, others use an unclassified balance sheet. Whether an entity uses a classified balance sheet or unclassified balance sheet has to do with industry accounting practices. A classified and unclassified balance sheet is not comparable at the level of current and noncurrent assets and liabilities because an unclassified balance sheet does not make that distinction. However, the balance sheets are comparable should you choose to compare them at the assets and liabilities and equity level. Likewise, a multi-step⁷ income statement which reports gross profit is not directly comparable to a single-step income statement which does not report gross profit. However, there are levels of comparison which can be achieved and certain industry practices which, if followed, allow for more comparability.

Also, this is not to say that entities cannot change policies or other practices. They can. However, there are specified ways for doing so.

⁷ To better understand comparability, see this information on report frames, <http://www.xbrlsite.com/2015/fro/us-gaap/html/ReportFrames/>

And so to be clear, there is no requirement that every line item of every financial report be directly comparable. It is very possible to compare entities which use different accounting practices and policies. Professional analysts understand how to perform appropriate comparisons. Having 100% consistency between entities is likewise not a requirement.

Stating that something is consistent with some description is different. Describing a financial report universally as having the relationship (business rules) "Assets = Liabilities and equity" and that a financial report is consistent with that description or rule is a different way to view consistency. This view is just as valid, just describing somethings slightly different.

Keeping these different definitions of consistency and comparability straight are important.

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